African Intelligence Report

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South Africa

The global economic backdrop is generally positive for the South African economy, despite the negative impact of declining commodity prices on the export earnings and trade deficit. The low oil price should have a meaningfully positive impact on the trade deficit, as South Africa is a significant net importer of oil.

According to renowned consulting economist Cees Bruggemans, the South African oil import bill last year in June was US$20bn, on an annualised basis. At the current oil price of just below US$50/barrel the oil import bill drops to US$9bn, which equates to 3% of GDP. The decline in prices of exported commodities negates approximately a third of the oil import gains. The net benefit, however still shaves off 1.5% of the current account deficit which, when last reported, stood at 6% of GDP. This net benefit should be supportive of a stronger Rand in the near term. The outlook for inflation has also improved, which means the likelihood of higher interest rates have diminished to a large degree. The authorities should not need to hike rates but, if they do, the correct "signal" will have to be sent to foreign investors to protect the Rand and foreign funding of the current account deficit.

It is likely that forecast economic growth will be adjusted upwards following the slump in the oil price and expected steady interest rates. Local GDP growth is expected to be 1.5% in 2014 and 2.8% in 2015, according to RMB Global Markets Research. The big negative factor that could undermine this bullish scenario will likely be Eskom and local power supply constraints. The finance minister announced, in the medium term budget review, that R10bn of the R20bn cash injection needed by Eskom has already been raised. It is expected that the balance will be funded by an increase in the fuel levy in the February budget review. We also expect higher taxes for the rich, which ought not to materially impact the fairly bullish growth outlook, as the benefit of lower fuel prices should have a greater positive impact on the broader middle and lower income groups of the population.

The local stock market, after returning 10.5% in 2014, had a positive start to the year with the JSE All-Share up 3% at the time of writing. Given the slump in crude prices, with the expected positive impact on local interest rates and inflation, Retail stocks had a strong start to the year with the Index up 14.6% in January alone. Banking stocks followed suit with the Index up 5.6%, as they are often viewed as a proxy for retailers. The announcement by the ECB heralded a search for yield by foreign investors and the movement in the Bank and Retail stocks was mostly due to foreign buying. The negative performers were mostly Resource stocks as weakness in spot commodity prices persists, given slow global GDP growth (particularly slowing growth in China) and major oversupply imbalances in most bulk commodities.

In terms of valuation, in absolute terms, the stock market does not appear to be in "bubble territory" yet but it is nearing over-valued levels. We expect earnings growth for 2015 to be in the region of 12%, which equates to a forward PE of 15x. The lower oil price and stable rates should be a fillip to earnings but it is still too early to estimate the impact on the upcoming numbers.

Sub-Saharan Africa

The New Year began on a weak note in Sub-Saharan Africa with Nigeria, in particular, suffering as the oil price collapsed further and the regional MSCI Africa Ex SA Index falling by 5.6%. The Nigerian SE Index declined by 14.8% but, with the devaluation in the Naira against the US Dollar, the Index fell 16.8% in Dollar terms. Indeed the Dollar was stronger against most African currencies during January. North Africa saw the larger declines, with the Moroccan Dirham falling 5.7%, given its close links with the Euro. The Egyptian Pound, which has been managed by the Central Bank, was allowed to fall closer to the "black market" rate in an attempt to move toward a market-related exchange rate and fell by 5.8%, having been stable for most of 2014.

The Mauritian Rupee was also weaker, declining by 3% - possibly engineered by the Central Bank - as tourism is reliant on the European market. Mauritius traditionally favors a strong Euro against the Dollar, as tourism receipts are typically in Euros and imports (mainly energy) in Dollars. The decline in the oil price however makes this link less important. Botswana, on the other hand, likes a strong Dollar for its 'terms of trade' as its principal export is diamonds that are priced in Dollars whilst the bulk of their imports come through South Africa in Rand.

In terms of regional indices – in Dollar terms - the Egyptian stock market rose by 2%, Kenya and Zimbabwe by just over 1% while Botswana and Zambia declined by 1.5%, largely due to the currency adjustment. Volumes have started to pick up after the Christmas break but are still well down on 2014. As reported last month, the uncertainty with regard to the implementation of the capital gains tax on equities in Kenya has kept volumes lower than might have been the case. Meanwhile talks between the local stockbrokers and the tax authorities have broken down again. This could prove problematic at some point, since the brokers have not been collecting any tax as yet.

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The Zambians held their elections following the death of their President last year. Turnout was very low, at just 34%, which was explained by the heavy rains that Zambia traditionally enjoys at this time of year. (Elections are usually held in winter). The ruling party candidate Edgar Lungu, former Defence Minister, won in a very close contest against "HH", a businessman and technocrat who lost by 16,000 votes. Lungu has only sixteen months to rule until the elections are held under the usual timetable. His mandate is to continue with the policies of his predecessor, which will focus on the improvement to the road infrastructure as a primary policy. Former President Sata was out of touch with industry and business and hence his policies tended to do more harm than good. As a 58 year-old lawyer, it is hoped that Lungu will view business more favorably. This is especially the case with the Mining sector, which ultimately brings in a significant proportion of Zambia's foreign exchange. The copper price has weakened significantly, but worse is the proposed 20% royalty tax on revenues, which will make most mines loss-making and ultimately lead to mine closures and a halt to new investment. His first priority needs to focus on engaging with the mines to ensure that this does not happen. With only sixteen months to run, it is in his interests to do so!

It is still too early for corporate results for the year ending December. BAT group companies are usually the early reporters. In Botswana, Sefalana announced their six-month results to the end of September, which were strong. These included (for the first time) their Namibian acquisition, which by all accounts has been a great success. The results also contained the diluted earnings per share numbers following last year's rights issue. Net profits rose by 23% on the previous year and earnings per share by 6%. Management's outlook was positive and hence the stock is well bid in the market.

Nigeria is due to hold elections in two weeks' time despite the fact that a third of the electorate will not have the biometric ID cards needed to vote. It looks to be a close call but Goodluck Jonathan should live up to his name and win the Presidency, not least as he has the State and Party machinery behind him.

Nigeria

The MSCI Nigeria Index fell 16.3% in US Dollar terms while the local currency, the Naira fell by 2.3%. The Nigerian SE Index fell by 16.7% in Dollars following an even sharper fall in Dangote Cement. The fall in the Index took prices back to the levels in mid-December before the sharp, window-dressing bounce over year-end. In fact, most of the fall in the stock market, the oil price and the currency took place in Q4.2014 as the Dollar surged. At stock level, Guinness, GT Bank and Nestle each fell by 20-25% in Naira terms. Unilever and StanbicIBTC both fell by 6% while Nigerian Breweries fell by 16.7%. PZ Cussons rose by 20%. The average fall since the 52-week high is 32% spread fairly evenly – similar to the three-month fall in the price of oil.

At this level, the Banks look cheap. The discount to fair value is around 20% and the expected dividend yield for 2015 approximately 10%. The banks may actually gain from the devaluation following the growth in Dollar-based lending as indigenous companies borrowed to buy oil fields from multinational companies. The banks have also stressed that there is no cause for concern over oil-backed loans if oil stays above US$40-50/barrel. There seems little doubt that this year will be a year of tightening, with potential for further devaluation and interest rate rises. One stockbroker recently reported a "black market" rate of N220 at Lagos airport (i.e. a 14% discount to "spot" from here) vs. a non-deliverable twelve-month forward rate of N253 and "spot" rate of N193.

The Domestic Consumption stocks have seen analysts lowering fair values at the same pace as the fall in the price of oil, so these seem fully valued as a consequence. The truth is hard to fathom. As the IMF says, the channels from the oil sector to the non-oil sectors are limited to government spending (which the IMF projects at 22.3% of GDP for 2015 - of which 65% is funded from oil and gas revenues); as a result, the underlying productive base of Nigeria should not be too negatively affected by an oil price fall whilst consumers and agricultural inputs benefit from falling petrol and feedstock prices. Oil's share of GDP is actually quite low - even though it accounts for 95% of export revenues - as Agriculture and Services (in particular) and are now large parts of the economy (about 75%). These non-oil sectors have generated strong and steady growth in recent years of between 8 and 10%. The IMF still expects Nigeria to grow by 5% this year and the current account surplus is projected at 2.8% of GDP. While greater competition and political instability continue to affect sentiment on the consumer stocks, devaluation is possibly a more significant factor for the sector. While most consumer stocks are modestly affected by devaluation, or have a linear relationship with a weaker Naira, PZ Cussons and Unilever are more affected, so we would expect poor results to persist for these two throughout the year - broker estimates have already been cut by 30-40% for 2015-17. At current prices, The EV/EBITDA ratio for many local companies for 2015 is in line with developed and emerging market averages of around 12x. The dividend yield is an un-weighted 3.1%. The outliers would be Nestle on 19.7x EV/EBITDA, which is 50% more expensive than its parent (but the same price as Nestle Malaysia), and Unilever on 15.9x, which is 32% more expensive than its UK parent but 40% and 22% cheaper than Unilever Indonesia and Hindustan Lever respectively. Nigerian Breweries (on an average 12x) and Guinness are now 20% and 50% cheaper than SAB Miller. PZ Cussons, which trades on 12.5x, is 20% more expensive than its UK parent, but price action suggests that the parent is once again trying to buy minorities. EBITDA margins remain at world class levels (>20%) for the beer companies and Nestle; for PZ and Unilever they are lower, at around 11% but both companies have spent heavily on route-to-market capex in recent years following the petrol price rise of 2012 and increased Chinese competition.

A further fall in the price of oil is the main risk, as government spending would have to be cut further. The current budget is based on US$67/barrel but the Government is waiting to see the trading range of the oil price before changing the reference price again. In parallel, market expectations of a further devaluation are starting to affect investor behaviour. Banks have had access to foreign exchange curtailed to protect the Naira, so the outflow of capital could accelerate if JPMorgan drops Nigeria from its Government Bond Index citing repatriation difficulties. More positively, the US dollar now looks overvalued by 10% on a real effective basis, but a stable Dollar and oil price, and current low petrol prices would be the best background for equities. Elections are also due this month, it's too close to call but Jonathan is the incumbent and hence favourite with a third of voters still to receive biometric polling cards.

Zimbabwe

Signs of stabilisation at last and a recovery in a stock market that fell 17% during the final quarter of 2014. Volumes in January, however remained very low as the implementation of the Central Depositary System for share certificates continues; completion now likely by the end of March. The ZSE Index rose 1.3% in January with the blue chip names once again appearing in the top ten performers. Barclays Bank jumped by 30%, OK Supermarkets by 21.7%, Delta by 9% and BAT Zimbabwe by 2.7%. Best performing stock was Truworths, the clothes retailer which increased by 60%, recovering much of what it had lost in 2014 on tiny volume! Given the lack of volumes, at least a third of the Index was unchanged -this has proved a very tough time for Zimbabwean stockbrokers.

Being January, there has been very little news to entice investors either into or out of the stock market. Corporate results for the December year-end will start with BAT towards the end of February, although sometimes Barclays sneaks in ahead of them! Delta, as an SAB Miller Group company, gave a trading update for Q4.2014; while volumes were still down on the previous year, as expected, encouragingly the rate of decline has slowed, suggesting that recent price cuts in their lager segment are having a positive affect. This was also before the recent excise duty cuts which only came into effect on January 1st 2015. Soft drinks also saw the rate of decline slowing. Sorghum beer saw a slight decline in volumes, after a strong year, but this was due to capacity constraints rather than weak demand. Their new plant is due on stream in May during their new financial year which should alleviate these issues. Cash flow for the business remains strong despite recent investments into capacity and distribution. We believe we will see a higher payout ratio announced for their year ending March 2015, thereby improving the yield for investors.

There has been little Political news of note. President Mugabe did not return from his holidays until the end of the month - as is the norm - although he came home alone, without his wife Grace. She apparently remained behind to be treated for appendicitis, although the rumour mill suggests that she was operated on for cancer! Mugabe was also appointed Chairman of the African Union, which comes in addition to his current chairmanship of the SADC countries - not bad for a man soon to be 91 years of age! Both appointments have taken him out of the country since his return from holidays and, as such, there have only been two Cabinet meetings held since mid-December. There has therefore been little in the way of policy pronouncements so far this year although the new policy to issue indigenisation certificates at the line Ministries rather that the Ministry of Indigenisation was finally gazetted. This is a step in the right direction.

The Government's crazy policy to pay a Christmas bonus (13th cheque) to the civil service has put a huge strain on their cash-flow, causing delays in some salary payments. It has also prompted the Ministry of Finance to seek ways to find additional cash revenues. In this regard, the Minister of Finance delayed his decision, made during his Budget speech, to delay the implementation of a 15% export tax on the platinum mines. The theory is to encourage the mining companies to build a refinery to "value-add" the platinum which they produce. In practice, however such an investment is expensive and takes a number of years to complete and, on completion, requires power to run it - something that Zimbabwe has little spare capacity for. The Minister, recognising this, delayed the tax until 2017. This delay never made the Finance Act that was passed in January, as he had decided to implement the tax anyway. This is very serious for the mining companies concerned, as it may make it unviable to continue mining, threatening any future investment. This appears typical of governments around Africa, which constantly change the rules, making long-term investment planning meaningless. Zambia has recently done the same to their copper mines. We hope that sense will prevail as Zimbabwe desperately needs foreign direct investment into its mining sector.

East Africa

The European Central Bank (ECB) finally unleashed its long-awaited Quantitative Easing (QE) program through an expanded asset-purchase program of up to US$68bn/month to September 2016, which further strengthened the US Dollar. In a major political development, meanwhile, Greece rejected economic austerity by decisively electing the left-wing Syriza Party, which sent a warning to the rest of Europe and kept the Euro under pressure. Most local currencies - except for the Rwandese Franc, which strengthened by 1% - weakened further against the US Dollar; the Uganda Shilling, Mauritian Rupee and Kenya Shilling declined by 3.2%, 2.8% and 1.2% respectively.
Kenya's Treasury reduced its domestic borrowing target for the 2014-2015 fiscal year by 24.1% to US$1.6bn (2.8% of GDP) from the previous target of US$2.1bn (3.6% of GDP), to prevent crowding out the private sector, free up more capital for private investment, support its economic

growth target of 6.9% for 2015 and maintain interest rate stability. The current fiscal deficit for 2015-16 is estimated at US$5.2bn (9.0% of GDP), 40.0% (US$2bn) of which will be financed through domestic borrowing and 60% through external borrowing. The International Monetary Fund (IMF), meanwhile, approved a US$688.3mn precautionary loan for use in mitigation against potential shocks to the economy; US$380.0mn will be advanced in the next fiscal year, and the rest in two equal tranches. The Treasury intends to use the facility to support the Kenya Shilling against shocks by bolstering foreign currency reserves amidst a waning KES/USD exchange rate, attributable to reduced revenue streams from agricultural imports, the easing of global coffee & tea prices, falling tea yields and reduced tourist arrivals due to insecurity, amid rising imports of oil, chemicals, manufactured goods, machinery and transport equipment, which adversely affected the trade balance account, hence forex inflows. The Central Bank of Kenya currently holds foreign currency equivalent to US$7.2bn.

Uncertainty due to a stalemate between the Kenya Revenue Authority (KRA) and the Kenya Association of Stockbrokers and Investment Bankers (KASIB) over implementation of Capital Gains Tax (CGT), which was re-introduced after a 30-year hiatus effective 1st January 2015, resulted in a steady decline in trading activity at the Nairobi Securities Exchange (NSE) with equity turnover declining to US$107.9mn in January, from US$356.6mn in December while foreigners were net sellers, recording outflows of US$2.9mn versus inflows of US$16.7mn in December. CGT targets net gains on sales of land, property and securities (shares and government securities) at an applicable tax rate of 5%, targeting both residents and non-residents. KASIB's concerns revolve around applicability and implementation, specifically the unilateral decision by KRA to appoint stockbrokers as collecting/ accounting agents and the requirements that CGT filing be done after every transaction. KASIB avers that, in markets where CGT is in effect, the onus is on the individual, who is then required to file once a year, along with their other tax obligations. With the differences between these institutions as yet unresolved, the matter appears headed to the courts.

In Uganda, the Shilling continued to depreciate against the USD, largely due to the strengthening of the USD against other international reserve currencies, indicating a possibility of higher inflationary pressures. After depreciating by 9% in 2014, the local currency was expected to remain generally weak for most of Q1.15 on the back of an unfavourable trade balance. During the month, the Central Bank indicated their intent to curb speculative demand, which it blamed for the currency's steep fall (3% since the beginning of the year) and mopped up more than US$87.78mn of excess liquidity via a seven-day repurchase agreement, a continuation of actions of previous months through frequent absorption of excess liquidity by raising the cost of holding onto long USD positions.

In Mauritius, the Government announced its infrastructure plan for 2015-2019. Over the next five years, public infrastructure and land transport will be a key component in transforming Mauritius into a modern, eco-friendly, vibrant and attractive place to live, visit and do business, and will involve an overhaul of the country's transportation systems. A new road decongestion programme will be put in place with a view to alleviating traffic congestion along the main arteries of the country and several main roads, highways, flyovers and secondary roads will be constructed. In Tourism news, arrivals in December (120,784) were up 3.2% YoY, which was the highest ever recorded number and the ninth consecutive record month. The country beat expectations for the year with just over one million tourists (+4.6% YoY). (Later in January - part of the peak tourist season - several flights were cancelled due to cyclone Bansi).

Rwanda's economy appears firmly back on an upward trajectory, with GDP growth of 7.8% in Q3.14, higher than the Government's projections of 6%. Services and Agriculture sectors remain the main drivers of growth, accounting for 47% and 34% of GDP respectively. According to the National Institute of Statistics of Rwanda (NISR), during the period, the economy generated goods and services worth US$2bn, up from US$1.8bn produced during a similar period in 2013. Indications of an economic rebound from the 2013 slowdown began to appear Q1.14, when the economy grew by 7.4% followed by 6.1% in Q2.14, an increase from 4.7% during the previous year.

Resources

The rout of mining shares continued through January as the MSCI World Commodity Producers Index* (major global mining companies) fell 4.6%. We saw currency risk playing a more significant role over the month: Resource shares are typically listed on the London, Canadian, Australian and South African stock exchanges and are therefore exposed to the inherent currency risk.

China has dominated the global demand for commodities for the past decade. Mysteel (China) reports "that local demand for steel in 2014 followed the slowdown in real estate investment, and that the industry was saved as steel exports surged 60% in 2014 - accounting for half of all newly added steel products". Mysteel further indicated that its "Composite Steel Price Index of China plummeted 9.3% over the past month and 23.8% over the past twelve months". More recently, the Hebei Steel Industry new orders monthly index came in almost 38% lower at 29.1% - the lowest level since September 2010.

We are seeing analysts and fund managers declare resource stocks as being cheap on a long-term sector relative basis; however we think that they will have to adjust long-term commodity prices downwards for valuation purposes, and would expect to see Private Equity action, before equity investors properly commit to resource stocks.

Lower long-term commodity prices are likely because of: weak demand (deflationary pressures); excess supply; much lower fuel input costs; weaker 'resource country' currencies; technology changes; balance sheet debt restructuring; and significant government controlled supply. The fact that the Baltic Dry Index has fallen 65% to 509 since early November – the lowest since August 1985 – highlights the challenging commodities environment.

Corporate news of note included the following:

Unlisted New Dawn faces huge challenges in trying to operate its gold mines in Zimbabwe: it's Indigenisation Plan was unduly delayed by Government; wages, power and rising indirect taxes; the 5% royalty is not tax deductible; local Fidelity Refining costs are 2.4% higher than in South Africa; and bank liquidity is tightening. In addition, after twenty years, the CEO has now decided to curtail his role in the business.

Strong market sentiment against resource stocks has precluded Eritrean gold explorer Andiamo Exploration from listing. Instead Andiamo concluded a share subscription agreement with Ortac Resources and a "farm-in" deal with Environmentals East Africa Ltd, which brought in funding and skills. Andiamo is exploring parts of the Arabian-Nubian Shield in Eritrea, which has potential for Volcanic Massive Sulphides and vein-type gold deposits. Ortac's recent results cannot yet be disclosed, but management believes "that the gold and copper deposits at Yacob Dewar are large enough and of sufficient grade that they are likely to be economically viable".

In its Q4.14 report, Middle Island management says "that perceptions around West Africa remain challenging for junior explorers. All are being tarred with the Ebola brush, regardless of jurisdiction, and political events are ever-present". The Company is in "survival" mode: looking at partial disinvestment in some of its projects; closing its office in Niger; moving its headquarters in Burkino Fasa to smaller premises and making all but two staff redundant. It is even looking at gold prospects back in Australia, given the recent weakness in the AUD. As at the end of December 2014 MI held A$1mn in cash and had no debt.

Tiger Resources' plan to treat High Sulphur Ore and so add an extra year to the life of the HMS plant has been shelved. This means that additional low-cost revenues are deferred until this material can be treated through the SXEW plant; more important, however, is that copper cathode production from the SXEW plant exceeded nameplate capacity of 25kt by 3% in Q4.14. Copper cathode was produced at an all-in-sustainable cost of US$3880/t, which represents a 41% margin. The success of the SXEW plant has prompted the company to speed up the feasibility study to double cathode production to 50ktpa. Timing of the expansion is being hindered by the +20% fall in the copper price and the need to renegotiate its debt facilities.